QUESTIONS PRESENTED

1. Whether the Commissioner properly reconstructed petitioner's taxable income under the bank deposits and cash expenditures method.

2. Whether the Commissioner properly imposed additions to tax against petitioner for negligence under Section 6653(a) of the Internal Revenue Code and for substantial understatement of tax liability under Section 6661 of the Code.

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In the Supreme Court of the United States

OCTOBER TERM, 1994

No. 94-1229

JOSEPH P. CAULFIELD, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A32-A38) is reported at 33 F.3d 991. The opinion of the Tax Court (Pet. App. A1-A31) is unofficially reported at 66 T.C.M. (CCH) 710 (1993).

JURISDICTION

The judgment of the court of appeals was entered on August 29, 1994. The petition for rehearing was denied on October 19, 1994. The petition for a writ of certiorari was filed on January 17, 1995. This Court's jurisdiction is invoked under 28 U.S.C. 1254.

STATEMENT

1. During 1982 and 1984, petitioner was a self-employed insurance adjuster. His income tax return for 1982 reported gross business receipts of $380,891 and business expense deductions of $380,379; his return for 1984 reported gross business receipts of $760,249 and business expense deductions of $773,200 (Pet. App. A3).

Upon audit, the Commissioner determined that petitioner's books and records did not accurately reflect his business receipts. Because of the absence of adequate records, the Commissioner reconstructed petitioner's income using the bank deposits and cash expenditures method (Pet. App. A4). Based on this reconstruction, the Commissioner determined that petitioner had underreported his income for both years. The Commissioner therefore issued notices of deficiencies and additions to tax to petitioner (Pet. App. A13).

2. Petitioner contested the Commissioner's determinations in Tax Court. After trial, the Tax Court held that petitioner failed to carry his burden of proving that he did not realize the additional income determined by the Commissioner (Pet. App. A13). The court therefore upheld the deficiency determinations and the additions to tax for negligence and substantial understatement of tax under Sections 6653 and 6661 of the Internal Revenue Code (Pet. App. A30-A31).

3. The court of appeals affirmed. The court rejected petitioner's contention that his records of income and expense were adequate and that reconstruction of his income was therefore improper (Pet. App. A33-A35). The court noted initially that petitioner had not preserved this issue for appeal because, in the Tax Court, petitioner "'[did] not challenge [the Commissioner's] finding of inadequate records or otherwise

seriously question [her] authority to reconstruct his income'" (Pet. App. A34). The court concluded that petitioner's contention was in error in any event, for "the problem in this case is not what [petitioner's] records showed, it was the substantial *unrecorded* taxable income" (*ibid.*).

The court of appeals further determined that the findings of the Tax Court upholding the Commissioner's reconstruction of petitioner's income were not clearly erroneous. The court noted that, even if some minor errors occurred in the reconstruction, "[t]axpayers who cannot produce adequate records 'may not complain of the inevitable inaccuracies in assessment their default occasions'" (Pet. App. A36, quoting *Dodge* v. *Commissioner*, 981 F.2d 350, 353 (8th Cir. 1992), cert. denied, 114 S. Ct. 58 (1993)). Because petitioner had substantially underreported his income, the court sustained the penalties and additions to tax imposed under Sections 6653 and 6661 of the Code (Pet. App. A36-A38).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. Petitioner contends (Pet. 10) that reconstruction of his income by indirect methods was improper because he maintained adequate records for the years in issue.[1] But,

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[1] In the Tax Court, petitioner "'[did] not challenge [the Commissioner's] finding of inadequate records or otherwise seriously question [the Commissioner's] authority to reconstruct his income'" (Pet. App. A13). The court of appeals thus properly determined that petitioner failed to preserve this issue for appeal (Pet. App. A34). See *Singleton* v. *Wulff*, 428 U.S. 106, 120 (1976); *Scallen* v. *Commissioner*, 877 F.2d 1364, 1375 (8th Cir. 1989).

even when a taxpayer keeps books and records that appear to support the return as filed, it is well established that the Commissioner may determine the taxpayer's income through indirect methods. *Holland* v. *United States*, 348 U.S. 121, 132 (1954); *Blackwell* v. *United States*, 244 F.2d 423, 427 (8th Cir. 1957), cert. denied, 355 U.S. 838 (1957); *Schwartzkopf* v. *Commissioner*, 246 F.2d 731, 733-734 (3d Cir. 1957). Moreover, as the court of appeals stated in this case, "the problem [here] was not what [petitioner's] records showed, it was the substantial *unrecorded* taxable income" that they did *not* show (Pet. App. A34). The inaccuracy of petitioner's books and records was confirmed by the Commissioner's reconstruction of income. Petitioner's assertion that the Commissioner should be required to accept petitioner's erroneous records at face value simply lacks any support.

2. Petitioner asserts that the Commissioner's determination of a deficiency in his tax was not entitled to a presumption of correctness because the Commissioner failed to show a "rational basis" for the determination. Petitioner correctly observes that "the Commissioner must have some reasonable foundation for the assessment to preserve the presumption of correctness" and the Commissioner "must do more than calculate income based on speculation" (Pet. 11). Petitioner errs, however, in contending that the Commissioner's determinations were based on "speculation."

The Commissioner's reconstruction of income was based on petitioner's bank deposits and cash expenditures during the years in issue, most of which were stipulated to by petitioner (Pet. App. A2-A13). In these

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Petitioner concedes that he "did not focus on the adequacy issue" (Pet. 9).

circumstances, the contention that the deficiency determination was based on speculation or had no rational basis lacks any plausible support.

3. Petitioner also errs in contending (Pet. 11-12) that slight errors found in the calculations underlying the notice of deficiency deprive the Commissioner's determination of the normal presumption of correctness. In the absence of adequate records, the Commissioner's reconstruction of petitioner's income was necessarily a reasonable estimate. It has consistently been held that, so long as a reasonable method is used for reconstruction of income, the taxpayer cannot complain of the inevitable inaccuracies that result from the taxpayer's failure to keep adequate records.[2] *Dodge* v. *Commissioner*, 981 F.2d at 353; *Rowell* v. *Commissioner*, 884 F.2d 1085, 1087-1088 (8th Cir. 1989). Mathematical exactitude is not required of the Commissioner. If it were, it "would be tantamount to holding that skillful concealment is an invincible barrier to proof." *Petzoldt* v. *Commissioner*, 92 T.C. 661, 693-694 (1989), quoting *United States* v. *Johnson*, 319 U.S. 503, 517-518 (1943).

The calculations underlying the notice of deficiency were accurate under the circumstances. Although certain items, such as the opening balances of petitioner's bank accounts, were understated in the computation in the notice of deficiency, the proper figures were stipulated prior to trial and were reflected in the Tax Court's decision. Indeed, as the Tax Court stated, "the unreported income determined by [the Commissioner] for each of the years in issue is *less* than

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[2] The bank deposits and cash expenditures method is a reasonable method for reconstructing income. See *United States* v. *Abodeely*, 801 F.2d 1020, 1023 (8th Cir. 1986); *Kearns* v. *Commissioner*, 979 F.2d 1176, 1177 (6th Cir. 1992).

the amounts that would have been determined using the deposits stipulated by the parties" (Pet. App. A17; emphasis added). Petitioner cannot establish any harm from a deficiency calculation that was less than the amount of tax ultimately determined due.[3]

4. Petitioner errs in contending that the decision in this case conflicts with the established proposition that loan proceeds are not income (Pet. 15, citing *Commissioner* v. *Indianapolis Power & Light Co.*, 493 U.S. 203, 207 (1990); *Commissioner* v. *Tufts*, 461 U.S. 300, 307 (1983)). As the Tax Court explained (Pet. App. A22-A23), the Commissioner properly made allowance for the non-taxability of loan proceeds by subtracting the stipulated amount of loan proceeds from petitioner's total deposits to arrive at a net figure representing taxable business receipts.

5. The courts below also properly sustained the imposition of additions to tax against petitioner under Section 6653(a) of the Code for negligence and under Section 6661 for substantial understatement of tax liability. With respect to the additions to tax for negligence, the court of appeals noted (Pet. App. A36) that petitioner "presented no evidence on this issue other than to defend the accuracy of his tax returns." Because petitioner's books and records did not report all

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[3] Petitioner errs in contending (Pet. 12-13) that the Commissioner failed to take into account nontaxable income purportedly received from the settlement of lawsuits. As the Tax Court noted (Pet. App. A24), petitioner introduced no documents to substantiate the assertion that he received nontaxable income. Indeed, the only evidence offered by petitioner on this point was his testimony that he received an unspecified amount of funds from such settlements at some unspecified time in the 1980's. That testimony was insufficient to carry petitioner's burden of proof to demonstrate that the deficiency was inaccurate (Pet. App. A13).

of his business receipts and the Commissioner therefore was required to reconstruct his income, the courts below correctly concluded that the deficiencies in petitioner's income taxes were attributable, at least in part, to his negligence (*id.* at A36-A37). Moreover, since there was a "substantial understatement" of tax within the meaning of Section 6661 of the Code for petitioner's taxable years 1982 and 1984, he was liable for the addition to tax imposed by that Section unless he established substantial authority for his position. See 26 U.S.C. 6661(b)(2)(B)(i) and (c). As the court of appeals noted (Pet. App. A37), petitioner did not establish any substantial authority for his failure to report income.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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